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October 12, 1994

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BY HAND DELIVERY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: **PP Docket No. 93-253**

Dear Mr. Caton:

On behalf of Bastion Capital Fund, L.P. and LM Capital Fund II, L.P., submitted herewith are an original and nine copies of its Ex Parte Comments on Petitions For Reconsideration. These Comments should be associated with the petitions for reconsideration of the Commission's Fifth Report and Order in the Competitive Bidding Rulemaking, PP Docket No. 93-253 (released July 15, 1994).

Respectfully submitted,


Meredith S. Senter, Jr.

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BEFORE THE

Federal Communications Commission

WASHINGTON, D.C. 20554

OCT 12 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)
)
Implementation of Section 309(j)) PP Docket No. 93-253
of the Communications Act -)
Competitive Bidding)

**EX PARTE COMMENTS
ON PETITIONS FOR RECONSIDERATION**

**BASTION CAPITAL FUND, L.P.
LM CAPITAL FUND II, L.P.**

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October 12, 1994

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SUMMARY

Bastion Capital Fund, L.P. ("Bastion"), and LM Capital Fund II, L.P. ("LM"), are minority-controlled limited partnerships formed for the primary purpose of investing in businesses owned by members of minority groups and women pursuant to the minority/women investment programs of various state-sponsored pension funds. Bastion and LM qualify as Venture Capital Operating Companies ("VCOCs") under the U.S. Department of Labor regulations governing investments by pension funds. As VCOCs, Bastion, LM and similarly situated funds ("Minority VCOCs") are required to take an active role in the management of companies in which they invest.

Minority VCOCs are uniquely positioned to provide financial and management assistance to the "control group" of PCS applicants owned by members of minority groups and women. But under Section 24.720(c) of the FCC's Rules, as currently drafted, Minority VCOCs are not permitted to invest in such a "control group" because their limited partners, which at present consist of state pension funds, are not 100 percent minority owned.

The Congressional purpose behind the requirement that the Commission promote "economic opportunity" for minorities and women in PCS would be furthered by treating Minority VCOCs as members of minority groups for purposes of determining whether a business is minority or women-owned. For example, control groups funded by Minority VCOCs are more

likely to include minority and/or female managers and employees. By permitting Minority VCOC participation in "control groups," the Commission can also avoid the alleged need to dilute to below 25 percent the minimum equity ownership required by women or minorities.

To further promote minority and women ownership, the Commission should also make clear that minority and female equity includes "carried interests," i.e., interests in the venture's profits in excess of the pro rata percentage of equity actually contributed by members of minority groups or women. In addition, the Commission should permit PCS applicants to raise capital through the issuance of preferred stock (or comparable investment vehicles). As currently drafted, the Commission's Rules may be read to require PCS applicants to treat preferred dividends as equity distributions in which minority and/or women owners must share pro rata. To the extent that preferred stock is issued in lieu of debt, however, preferred dividends should not be treated as equity distributions, so long as a reasonable limit is placed on the maximum rate payable to prevent sham ownership structures.

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In the Matter of)
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Implementation of Section 309(j)) PP Docket No. 93-253
of the Communications Act -)
Competitive Bidding)

**EX PARTE COMMENTS
ON PETITIONS FOR RECONSIDERATION**

Bastion Capital Fund, L.P. ("Bastion"), and LM Capital Fund II, L.P. ("LM"), hereby submit these late-filed Comments on the petitions for reconsideration of the Commission's Fifth Report and Order in the Competitive Bidding Rule Making, PP Docket No. 93-253 (released July 15, 1994).

Without endorsing the specific proposals, Bastion and LM agree with those parties who have pointed out that the definition of "business owned by members of minority groups and/or women" in Section 24.720(c), as currently drafted, prevents certain important minority-controlled entities from participating in the "control group" of a PCS applicant.^{1/} In particular, the definition of "business owned by members of minority groups and/or women" prevents certain minority-controlled Venture Capital Operating Companies from participating in the "control group" of a PCS applicant. In addition,

^{1/} See Petition for Reconsideration of EATELCORP, Inc. at 6-7 (filed August 22, 1994); Comments on Petitions for Reconsideration and Clarification of BET Holdings, Inc. at 12-14 (filed September 9, 1994).

Bastion and LM recommend that the Commission clarify the definition of "equity" for purposes of determining minority and women ownership to make clear that "carried" interests qualify as equity.

I. DESCRIPTION OF BASTION AND LM

Bastion and LM are each limited partnerships formed for the primary purpose of investing in minority and women-owned businesses. As the Commission has acknowledged, capital formation is the greatest impediment to the entry of members of minority groups and women into the ownership of telecommunications businesses. Bastion and LM are intended to help minority and female business people bridge this gap.

A number of state pension funds have recently initiated programs for the purpose of addressing the lack of capital available to minority and women-owned businesses and the need of these businesses for management expertise and assistance. For example, the California Public Employees Retirement System ("CalPERS"), which is one of the largest pension funds in the world, with roughly \$80 *billion* in total assets, targets investments towards minority and women-owned businesses under its Alternative Emerging Investment Opportunities program. Pursuant to such programs, CalPERS and other state-sponsored pension funds have purchased limited partnership interests in and provided most of the initial funding for Bastion and LM.

Both Bastion and LM are minority controlled — by Hispanic individuals, in the case of Bastion, and by African-American individuals, in

the case of LM — through their general partners. These minority owners actively manage the partnerships and, as required by their respective partnership agreements and by law, are actively involved in the management of the companies in which they invest. Unfortunately (and perhaps in no small part due to the regulatory regime under which they must operate), very few similar minority-controlled Venture Capital Operating Companies have been formed to date pursuant to similar state pension fund-sponsored programs. We are aware of only three other such companies (hereafter "Minority VCOCs") that have been in operation during the past year.^{2/}

Although funded initially under state pension fund-sponsored programs, Minority VCOCs operate under federal regulatory scrutiny. Because their limited partners include pension funds, Minority VCOCs must comply with regulations of the U.S. Department of Labor under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The term "Venture Capital Operating Company" ("VCOC") is defined under the Labor Department's regulations that further define the permitted assets of pension plans under ERISA. Under these regulations, a VCOC is required to invest at least 50 percent of its assets in operating companies (companies primarily engaged in the production or sale of a product or service other than the investment of capital) in which it "has or obtains management rights," i.e.,

^{2/} These are Syndicated Communications, Inc., Fairview Capital Partners, L.P., and Penman, L.P.

contractual rights "to substantially participate in, or substantially influence the conduct of, the management of the operating company." 29 C.F.R. § 2510.3-101(d) (1993). A VCOC is thus required to provide an operating company not only with capital, but also with management assistance and expertise.

II. MINORITY VCOCs SHOULD BE PERMITTED TO PARTICIPATE IN THE "CONTROL GROUP" OF MINORITY AND WOMEN-OWNED PCS APPLICANTS.

A. Minority VCOCs Are Disqualified from Providing Funding to Minority or Women Control Groups Under the Current Rules.

Given that Minority VCOCs are formed and have been funded by pension funds for the purpose of investing in minority and women-owned businesses, and that they are required as VCOCs to take active roles in the management of the companies in which they invest, it is not surprising that Minority VCOCs have been approached about participating as active investors in the "control groups" of PCS applicants. Such participation would be consistent with their objective of investing primarily in minority and women-owned businesses.

As drafted, however, the Commission's rules prevent Minority VCOCs from investing in PCS applicants for Block C and Block F licenses. Under Section 24.720(c) as currently drafted, an entity qualifies as a minority or women-owned business only if it has a "control group" composed 100 percent of members of minority groups and/or women. Because of their

pension fund investors, Minority VCOCs are not 100 percent minority or women-owned, so they may not participate in the "control group" of a minority or women-owned applicant under the current rules.^{3/} At the same time, however, Minority VCOCs cannot qualify as holders of "passive equity" because (as discussed in Section I above) they are required by other federal regulations to participate in the management of any company in which they invest. Thus, under the current rules, Minority VCOCs may be unable to provide funding to minority and women-owned PCS applicants, notwithstanding their charters to invest in minority and women-owned businesses.

B. Minority VCOCs Should Be Treated As Members of Minority Groups for Purposes of Determining Whether a Business is Minority or Women-Owned.

In order to ensure active and meaningful minority and women ownership and management of broadband PCS licensees, Minority VCOCs are prepared to assist in the formation of and to fund minority or women "control groups," i.e., minority or women-controlled general partners of PCS applicants, assuming the Commission modifies its rules to permit such participation. Congress has tasked the Commission with promoting "economic opportunity" for minorities and women in PCS. See H. Rep. No. 103-111,

^{3/} Minority VCOCs are not literally "composed 100 percent of members of minority groups and/or women," because their limited partners are pension funds, whose beneficiaries may or may not be women and/or members of minority groups.

103d Cong., 1st Sess. 581 (1993). In addition to ownership opportunities, broadband PCS will create numerous new employment and managerial opportunities, and if properly encouraged and assisted, women and minorities could enjoy increased access to those positions as well. The participation of Minority VCOCs in "control groups" will serve this objective. Minority VCOCs can create opportunities for minority and women managers by providing them with needed financial resources and expertise in financial management. Because Minority VCOCs are minority-controlled, and because they have as an express purpose the promotion of minority and women-owned businesses, they are more likely to give minorities and women management opportunities than are other entities. More minorities and women can enjoy the "economic opportunities" to be created by broadband PCS through increased employment and managerial opportunities than through participation through equity ownership alone.

Congress's objective in requiring that the Commission give favorable treatment to minorities and women in auctions for PCS spectrum would therefore be served by permitting Minority VCOCs to participate in minority and/or women control groups as if the minority VCOC were 100 percent minority owned. To this end, Bastion and LM urge the Commission to create a very narrow exception to the requirement that the control group be composed 100 percent of members of minority groups and women. In particular, we recommend that the Commission add the following sentence to

the definition of "business owned by members of minority groups and/or women" at Section 24.720(c):

A Venture Capital Operating Company ("VCOC") (as defined under 29 C.F.R. § 2510.3-101(d) (1993) or any successor regulation) will be deemed a member of a minority group and/or a woman for the purpose of determining the eligibility of an applicant under this Part 24 if: (1) the VCOC is controlled by members of minority groups and/or women; (2) on a fully diluted basis members of minority groups and/or women have at least a 20 percent interest (which may include any "carried interest") in the profits and capital gains of the VCOC; (3) the VCOC will invest no more than 35 percent of its capital in PCS licensees; and (4) the passive equity of the VCOC is owned by pension funds or other institutional investors (in which case, the investors holding such passive equity shall not be considered affiliates of an applicant for purposes of Section 24.709).

As explained below, the exception would ensure that the control group as a whole would continue to own at least 25 percent of the equity of the PCS applicant; minorities or women would continue to exercise control over the PCS applicant; and minorities and/or women would be able to obtain financial and managerial assistance from VCOCs, which themselves are minority controlled and have meaningful minority ownership, and whose investors would be passive institutions.

First, the participation of Minority VCOCs in the "control group" would not in any way dilute minority or female control of a PCS applicant. By definition, the Minority VCOC would itself be minority-controlled. Moreover, as required under ERISA regulations and the Minority VCOCs' organizational documents, the controlling minority owners would

actively participate in the management of operating companies in which they invest, including PCS applicants.

Second, under the exception, the minority and/or women owners of the Minority VCOCs would be required to have a significant economic interest in their respective funds — at least a 20 percent interest (including any "carried interest"). This interest is consistent with the structure of existing Minority VCOCs. For example, each of Bastion's and LM's general partners has a twenty percent stake in the profits (both operating and capital gains) of their funds.

Third, a Minority VCOC would be required to have a diversified investment portfolio in order to ensure that only *bona fide* VCOCs qualify and that no "sham" VCOCs are created for the sole purpose of investing in PCS. None of the existing Minority VCOCs were formed for the specific purpose of investing in PCS. Instead, they are required to diversify their investments: they are generally prohibited from investing more than 20 percent of their assets in a single company or more than 30-35 percent in a single industry. We recommend that the Commission impose a similar limitation.

Fourth, ownership in the passive equity of Minority VCOCs would be limited to pension funds and other institutional investors, again to ensure that the exception would not be used as a vehicle for non-minority entities to profit from the minority preferences. Again, this is consistent with the existing ownership of Minority VCOCs. The pension funds that have

invested in Bastion and/or LM, for example, are passive institutional investors in the truest sense of term; they include CalPERS, New York State Common Retirement Fund, Pennsylvania School Employees Retirement System, City of Philadelphia Public Employees Pension Fund, and Massachusetts Bay Transportation Authority. CalPERS, as described above, invested in Bastion and LM as part of its Alternative Emerging Investment Opportunities program.

C. By Permitting Minority VCOC Participation in Control Groups, the Commission Can Avoid Any Further Dilution In the Equity Ownership of Minorities and Women.

Bastion and LM are very concerned that the FCC maintain in place rules that assure that minority and women-owned businesses are not mere "fronts" but represent meaningful ownership and managerial opportunities. In particular, *Bastion and LM oppose proposals to reduce below 25 percent the level of required equity ownership by minorities and women.* A reduction below this level would only encourage the creation of sham applicants and would unnecessarily reduce the level of minority and female participation in broadband PCS.

Other parties to this proceeding have argued that the enormous capital requirements for broadband PCS, irrespective of any "discount" that small businesses, minorities and women might receive in the auction for the license itself, necessitate a reduction in the required level of equity ownership

by minorities and women. Bastion and LM are concerned that in order to address these "financial realities," the Commission may relax its definition of minority and women-owned business to such an extent that minorities and women will not enjoy to the fullest extent possible the economic opportunities to be presented by broadband PCS. Based upon preliminary discussions and negotiations with various individuals and companies, it appears to Bastion and LM that most PCS applicants are being structured so as to result in ownership of 75 percent of PCS applicant's equity by "passive investors" under Section 24.709(b)(3)(i). Bastion and LM are concerned lest the role of minorities and women be further diluted.

As mentioned above, Minority VCOCs are ready, willing and able to step up to the plate should minority and female entrepreneurs need additional funding at the "control group" level. Pursuant to the minority/women-owned business investment programs of the pension funds discussed in Section I, and consistent with the regulations governing VCOCs, Minority VCOCs are structured to ensure that the funds raised are used primarily to assist small minority and women-owned businesses. Under their organizational documents, they are required to seek out investments in minority and women-owned businesses. Minority VCOCs have therefore been groomed to provide just the financial and managerial assistance minority and female entrepreneurs might need.

Accordingly, Bastion and LM urge the FCC to make the rule change requested at page 7 above so as to allow Minority VCOCs to participate fully in the "control group" of a minority or women-owned PCS applicant.

III. THE COMMISSION SHOULD CLARIFY THE DEFINITION OF EQUITY FOR PURPOSES OF DETERMINING WHETHER A PCS APPLICANT IS MINORITY OR WOMEN OWNED.

A. Minority and Female Equity Should Include "Carried Interests."

The Commission's competitive bidding procedures for broadband PCS in Subpart H contain no clear explanation of how the "equity interests" of members of minority groups and women will be calculated for the purpose of determining minority and female ownership of a PCS applicant. The fullest explanation of the meaning of "equity interest" in Subpart H is in the definition of "control group" in Section 24.720(k), which provides that the control group must "have the right to receive dividends, profits and regular and liquidating distributions from the business in proportion to its interest in the total equity of the applicant or licensee."

For the purpose of determining compliance with the limitations on cellular/broadband cross-ownership, Section 24.204(d)(vi) of the PCS Rules provides that limited partnership interests are calculated "according to both the percentage of equity paid in and the percentage of distribution of

profits and losses." Subpart H of the rules, however, is silent on the question of whether equity interests will also be calculated on a "capital contributed" basis for the purpose of determining minority and female ownership, although it could be argued that the omission of any reference to equity contribution in the definition in Section 24.720(k) means that the "capital contributed" rule does not apply. Notwithstanding that this purpose may be implicit, the Commission should make clear that the "capital contributed" rule of Section 24.204(d) does not apply for the purpose of determining the ownership interests of members of minority groups and women. The primary objective of promoting economic opportunity for minorities and women would be served by permitting such individuals or entities to have "carried" interests and by not attributing passive investors who contribute the "carry" with greater than their actual ownership interest. For purposes of determining eligibility under Subpart H, the Commission should therefore make clear that the term "equity interest" only includes the second half of the definition in Section 24.204(d)(vi), that is a percentage of distributions of profits and losses from operations, capital gains and divestitures.

B. Minority and Women-Owned PCS Licensees Should be Permitted to Pay Limited Preferred Dividends Without Diluting the Percentage of Minority and Female Ownership.

Bastion and LM also believe that it is crucial that minority and women-owned PCS licensees be able to offer sufficient incentives to attract

capital and possess the flexibility to use the lowest cost capital structure possible. Putting aside the cost of acquiring the broadband PCS license itself (much of which may be payable on an installment basis), the up-front capital demands on Block C and Block F PCS licensees will be particularly high. They will be required to relocate incumbent microwave licensees, construct a competitive system and market the service, as well as fund initial operating losses. Moreover, Block C and Block F licensees will operate in an extraordinary competitive environment. Not only will Block C and Block F licensees compete against two entrenched cellular providers and at least one SMR provider, but also against the Block A and Block B broadband PCS licensees, who will enjoy a head-start over the Block C and Block F licensees, as well as be licensed to provide service to a larger territory. Investment in minority or women-owned Block C and Block F licensees is therefore likely to be perceived by the financial community as riskier than investment in cellular or Block A and Block B licensees.

To reduce the cost of debt, a PCS licensee may find the issuance of preferred stock (or comparable investments in a limited partnership) attractive. Preferred stock reduces a company's cost of borrowing, i.e., the interest rate it must pay, because it lowers the company's debt/equity ratio. Preferred stock may also be attractive because it could give PCS licensees the ability in the start-up phase to defer the payment of preferred dividends, allowing them instead to accumulate.

A minority or women-owned PCS licensee, however, might not be able to use preferred stock at all if the payment of preferred dividends is taken into account in determining the equity interest of the control group under Section 24.720(k)(4). That rule might be read to require that the control group receive a pro rata percentage of all dividends, including preferred dividends and distributions. In effect, the rule might require that all equity held by the control group enjoy the same rights and preferences as equity held by any other investor.

Bastion and LM believe that, to a limited extent, minority and female-owned PCS licensees should be able to use preferred stock (or limited partnership interests having the essential characteristics of preferred stock) in lieu of debt without being unduly penalized. The Commission should, however, place limits on its use in order to prevent certain abuses that Bastion and LM have observed under other federal programs. For example, if an investor were to insist on a preferential 25 percent return on investment, this preferred return, compounded over the first five to ten years of operation (during which a PCS licensee is unlikely to generate any operating income), could effectively eviscerate the value of any "equity interest" held by the minority or female control group. Bastion and LM believe that such a potential for abuse can be avoided by limiting the rate of preferential return. We therefore recommend that the Commission permit minority or women-owned Block C and Block F licensees to pay preferential returns of no more

than the higher of ten percent or the rate on ten-year Treasury obligations plus 4 percent, without such payments diluting the equity interest of minority or female control groups.

IV. CONCLUSION

As minority-controlled VCOCs formed for the primary purpose of investing in minority and women-owned businesses, Bastion and LM are vitally interested in the Block C and Block F broadband PCS set-asides. Under the rules as currently drafted, however, Minority VCOCs cannot participate in minority and/or women control groups. This prohibition is inconsistent with Congress' objective of promoting economic opportunity in PCS for minorities and women generally and also frustrates the purpose of various state-initiated minority and women-owned business investment programs. Bastion and LM therefore urge the Commission to permit Minority VCOCs to participate in minority and/or women control groups by treating qualified Minority VCOCs as members of minority groups and/or women for purposes of the Rules. With this change, the Commission can avoid the alleged need to reduce the minimum level of minority/women ownership below 25 percent.

Bastion and LM also urge the Commission to clarify the calculation of equity interest for the purpose of determining minority and/or women ownership. The Commission should make clear that minorities and

women may own "carried interests" and that preferred dividends paid in lieu of interest on debt will not dilute equity ownership. An equity interest for the purpose of determining minority and/or female ownership should include an interest in the operating profits of the PCS licensee and the gain on the sale of the business, including "carried interests," calculated after taking into account any preferential return on equity to investors, not to exceed the higher per annum rate of 10 percent or the rate for ten-year U.S. Treasury obligations plus 4 percent.

Respectfully submitted,

BASTION CAPITAL FUND, L.P.
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Of Counsel

October 12, 1994

CERTIFICATE OF SERVICE

I, Cristina M. Lirag, hereby certify that true and correct copies of the foregoing "Ex Parte Comments on Petitions for Reconsideration were sent by hand delivery this 12th day of October 1994 to the following:

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Cristina M. Lirag